THE PROBLEM OF THE RUPEE:
ITS ORIGIN AND ITS SOLUTION
(HISTORY OF INDIAN CURRENCY & BANKING)

CHAPTER V

FROM A GOLD STANDARD TO A GOLD EXCHANGE STANDARD

For once it seemed that the problem of a depreciating rupee was satisfactorily solved. The anxieties and difficulties that extended over a long period of a quarter of a century could not but have been fully compensated by the adoption of a remedy like the one described in the last chapter. But by an unkind turn of events, the system originally contemplated failed to come into being. In its place there grew up a system of currency in India which was in every way the very reverse of it. Some thirteen years after legislative sanction had been given to the recommendations of the Fowler Committee, the Chamberlain Commission on Indian Finance and Currency reported that

> " in spite of the fact the Government adopted and intended to carry out the recommendations of the Committee of 1898, the Indian currency system to-day differs considerably from that contemplated by the Committee, whilst the mechanism for maintaining the exchange has some important features in common with the suggestions made to the Committee by Mr. A. M. Lindsay."

It will be recalled that in Mr. Lindsay's scheme Indian currency was to be entirely a rupee currency; the Government was to give rupees in every case in return for gold, and gold for rupees only in case of foreign remittances. The scheme was to be worked through the instrumentality of two offices, one located in London and the other located in India, the former to sell drafts on the latter when rupees were wanted and the latter to sell drafts on the former when gold was wanted. Surprisingly similar is the system prevailing in India to-day. Corresponding to Mr. Lindsay's proposals, which, be it noted, were rejected in 1898, the Government of India has built up two reserves, one of gold and the other of rupees, out of the cash balances, the paper currency, and the gold-standard reserve. Each of these is, by the nature of the currency system, composite. The cash balances, which are fed from revenue receipts, gather in their net rupees as well as sovereigns, both being legal tender. Notes being issuable against both, the paper-currency reserve always contains sovereigns and rupees. Up to August, 1915, the gold-standard reserve was also held partly in gold and partly in rupees. By a system of sorting, technically called " transfers," the Government secures the command over rupees and sovereigns necessary for discharging the obligations it has undertaken. The location of these funds is also very much as designed by Mr. Lindsay. The cash balances, being the till-money of the Government, are necessarily distributed between the Government of India in India and the Secretary of State in London, the portion held by the latter being entirely in gold and that held by the former being in silver. The gold-standard reserve, like the cash balances, is not a statutory reserve. Consequently its location is perfectly within the competence of the Executive. That being so, it has been so arranged that the gold portion of the fund shall be held by the Secretary of State in London, and the rupee portion, so long as it was maintained, by the Government of India in India. The only reserve which did not easily lend itself to currency manipulation was the paper-currency reserve, for the reason that its disposition and location were governed by law. In that behalf, legal power has been taken to alter the location of the gold part of that reserve by making permanent the provision of the temporary Act II of 1896, which authorised the issue of notes in India against gold tendered to the Secretary of State in London. Thus the Secretary of State and the Government of india, under the new system of currency, hold two reserves, one of gold, mainly in the possession of the former and located in London, and the other of rupees, entirely in the possession of the latter and held in India. But the similarity of the existing system to that of Mr. Lindsay is not confined to the maintenance of these funds and their location. It extends even to the modes of operating these two funds, For, as suggested by Mr. Lindsay, when rupees are wanted in India the Secretary of State sells what are called "Council Bills," encashable into rupees at the Government Treasuries in India, thereby providing the rupee currency in India. When gold is wanted the Government of India sells what are called " Reverse Councils " on the home Treasury in London, which are encashed by the Secretary of State, thereby providing gold for foreign remittances. The result of the sale of " Council Bills " and of the " Reverse Councils " on the two funds has been to transform the Indian currency from being a gold standard with a gold currency, as desired by the Fowler Committee, into what is called a gold standard without a gold currency, as wished for by Mr. Lindsay.

This system which has grown up in place of the system originally contemplated by the Government of india is called the gold-exchange standard. Whatever that designation may mean it was not the plan originally contemplated by the Government of India in 1398. How the departure came about we shall deal with in another place. Here it is enough to state—-one may also say necessary, for many writers seem to have fallen into an error on this point—*that the Government did not start to establish a gold-exchange standard.* Rather it was contemplating the establishing of a true gold standard, which, however inadequately understood by the men who framed it, was in essential agreement with the principles governing the English Bank Charter Act of 1844.

What are we to say about the new system ? The Chamberlain Commission, while reporting that there was a departure from the idea! of a gold standard with a gold currency, observed :—

> " But to state there has been this departure is by no means to condemn the action taken, or the system actually in force......"

Now why not ? Is not the system the same as that proposed by the Government in India in 1878 and condemned by the Committee of 1879 ? it is true the arguments urged against that plan by the Committee of 1879 were not of much weight. Nonetheless the plan was essentially unsound. The material point in the introduction of a gold standard must be said to be one of limitation on the volume of rupees, and it is from this point of view that we must judge the plan. But there was nothing in the plan of 1878 that could be said to have been calculated to bring that about. Far from putting any limitation on the volume of rupees, the plan had deliberately left the Mints open to the free coinage of silver. A matter of some interest in the plan was the projection of a system of seignorage so arranged so to make the bullion value of the rupee equal to the gold value given to it. But as a means of limiting the coinage of rupees it was futile. The mere levy of a seignorage cannot be regarded as sufficient in all circumstances to effect a limitation of coinage. Everything would have depended upon how closely the seignorage corresponded with the difference between the mint and market price of silver in terms of gold. If the seignorage fell short of the difference it would have given a direct impetus to increased coinage of rupees until their redundancy had driven them to a discount. In this respect the plan was a reproduction in a worse form of the English Gold Standard Act of 1816. Like the Government of India's plan of 1878, that Act, while purporting to introduce a gold standard, had authorised the opening of the Mint, which was closed, to the free coinage of silver with a seignorage charge. It is not generally recognised how stupid were the provisions of that Act, the ideal of all orthodox gold monometallists, in so far as they contemplated the free coinage of silver. Fortunately for England the Royal Proclamation, compelling the Mint Master to coin all silver brought to the mint, was never issued. Otherwise the working of the gold standard would have been considerably jeopardized. The Act of 1816 had at least taken one precaution, and that was a limit on the legal-tender power of silver. In the scheme of the Government of India, not only free coinage of silver was permitted, but silver was conceded the right of full legal tender. In so far, therefore, as the plan did not provide for controlling the volume of rupees it was subversive of the gold standard it had in view.

The only difference between this plan of 1878 and the system now in operation in India is that under the former the Mints were open to the public, while under the latter they are open to the Government alone. In other words, in the one case rupees were coined on behalf of the public, and in the other they are being coined on behalf of the Government. It is not to be supposed that the plan of closing the Mints to the public was not thought of by the Government in 1878. On the other hand, the Government of India had then considered the feasibility of taking over into its hands the coinage of rupees, and had rejected it on some very excellent grounds. In their dispatch outlining the scheme the Government of the day observed:—

> "48. The first point to be guarded in attempting to carry out the proposed change, is to provide for complete freedom for any expansion of the currency which the trade requirements of the country demand. This, we think could not be properly secured if the Mints were wholly closed for the coining of silver for the public. If this measure were adopted, the responsibility for supplying the silver demand would be thrown on the Government, and in the present position of the market for gold and silver bullion in India it would not be possible to accept such a duty.
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> "49. What might at first sight appear the simplest, and therefore the best way of allowing for the expansion of the Indian silver currency with a gold standard, would be for the Government to undertake to give silver coin in exchange for gold coin to all comers, at the rates fixed by the new system, and to open the Mints for the coinage of gold, while they were closed for silver. But in the absence of any supply of silver in india from which to obtain the necessary material for coinage, such an obligation could not be accepted, without involving the Government in complicated transactions in the purchase and storing of bullion which it would be very inexpedient to enter on."

With these reasons, interesting in so far as they were prophetic of the scandals connected with the recent silver purchases by the India Office, we are not directly concerned. What is of importance is whether this difference in the mode of issue makes any vital difference to the question of an effective limit on the volume of rupees. Now, there is a great deal of confused thinking as to the precise virtue of the closing of the Mints to the private coinage of silver. It was generally believed, the closing of the Mints having given a monopoly to the Government in the matter of issuing rupees, that this monopoly would somehow sustain the value of the rupees in terms of gold by preventing their over-issue. The closing of the Mints, it must be admitted, has given the Government the position of a monopolist. But how a monopoly prevents an over-issue is not easy to grasp. The closing of the Mints to the free coinage of silver is the same as depriving banks of the liberty of issuing notes and giving it exclusively to a central bank. But nobody has ever argued that because a central bank has a monopoly of issue it cannot therefore over-issue. Similarly, because the Government of India is a monopolist it would be absurd to argue that it cannot therefore over-issue. Indeed, a monopolist can issue as much as private people put together, if not more. Again, from the standpoint of influence of profits on coinage the present plan is much inferior to that of 1878. It is true in both cases profits depend upon the volume of coinage. But in the former the amount of profit was no incentive to coinage, either to the Government, because it had no power to coin, or to the people who determined the volume of coinage, because the regulation of seignorage practically controlled it by making it unprofitable to bring additional bullion to the Mint. In the present case, the coinage being entirely in the hands of the Government, a hankering after profits, generated by the silly notion of the necessity of a " backing " to the currency, might create an impulse to undertake additional coinage, especially if the price of silver fell very low and produced a wide margin between the Mint and the market price of the rupee.

If it is argued, as it well may be, that the will of the Government of India as a monopolist, i.e. its desire to see that its currency is not depreciated, may bring about a limitation on the issue of rupees which could not have been possible had the Mints remained open to the public in general, the reply is that this will to limit could be effective only if the Government had the power to refuse to issue. Central banks limit their currencies so far as will is concerned, because they are not obligated to issue to anyone and everyone. But the position of the Government of India is lamentably weak in this respect. It is bound to issue currency when asked for. It is true that every issue does not involve a net addition to the existing volume of currency; for a portion of the new issue is a re-issue of what is returned from circulation. Nonetheless, it cannot be said that the Government by reason of its monopoly has put an effective limit on the volume of rupee currency. On the other hand, having no escape from the liability to issue currency, the exercise of this cherished privilege has recoiled on the Government, so much so that this monopoly of issue, instead of strengthening the position of the Government, has weakened it considerably.

The View of the Chamberlain Commission

" that while the Government are very large dealers in the exchange market, they are not monopolists (!) and it seems doubtful if they could successfully stand out for any such [fixed minimum rate] at all times of the year,"

is therefore interesting as a confession that the closing of the Mints has not had the virtue of so limiting the coinage of rupees as to enable the Government to dictate at ail times the price of the rupee, which none but it alone can manufacture.

Thus the present standard is different from the standard proposed in 1878 only in name. If this one is characterised by the adoption of the rate of exchange as an index for regulating the volume of currency, the same must be said of the former. But as Mr. Hawtrey remarks, whatever means are adopted for the manipulation of the currency,

" the value of the rupee will be determined by the quantity in circulation."

in other words, what must be said to be essential for the safety of a gold standard is a provision against over-issue of rupees. But, as we saw, neither the plan of 1878 nor the present one can be said to be free from that danger. Consequently we must conclude that, being essentially alike, the arguments that are valid against the former are also valid against the latter.

But the Chamberlain Commission will not allow that the exchange standard is a resuscitation of a condemned plan. On the other hand, it has sought to inspire confidence in that standard by holding out

"that the present Indian system has close affinities with other currency systems in some of the great European countries and elsewhere......"

To get an idea as to what these affinities are, or rather were, we must look into Chapter II of Mr. Keynes's interesting treatise on *Indian Currency and Finance.* In that treatise of his, Mr. Keynes has attempted to show that there is a fundamental likeness between the operations of the Indian currency system and the operations as they used to be of the central banks of some of the important countries of Europe. He found that it used to be the practice of these banks to hold foreign bills of exchange for the purpose of making remittances to foreign countries. Between the selling of such foreign bills and selling of reverse councils by the Government of India he observed a close fundamental likeness, inasmuch as both involved

" the use of a local currency mainly not of gold, some degree of unwillingness to supply gold locally in exchange for the local currency, but a high degree of willingness to sell foreign exchange for payment in local currency at a certain maximum rate."

But, as Prof. Kemmerer points out, it is difficult to see what likeness there is between the Government of India selling reverse councils and the European banks holding foreign bills. Far from being alike, the two practices must be regarded as the opposite of each other. In selling reverse councils

"the Government sells drafts against its foreign gold credit (i.e. its gold reserve), when money at home is relatively redundant, as evidenced by exchange having reached the gold export point. Thereby it relieves the redundancy through the withdrawing from circulation and locking up the local money received in payment for the drafts. Under the practice of holding foreign bills to protect the money market, the central bank sells its foreign bills, when money at home is relatively scarce, as means of securing gold for importation or preventing its exportation. In the former case, the sale of drafts takes the place of an exportation of gold, and the resulting withdrawal of local money from circulation is in essentials an exportation ; in the latter case the sale of the drafts abroad is part of a process for securing gold for importation, or for preventing its exportation."

The Indian currency system therefore bears no analogy to the European currency systems, as Mr. Keynes would have us believe. But if a parallel is needed, then the true parallel to the Indian system of currency is that system which prevailed in England during the Bank Suspension period (1797-1821). The fundamental likeness between the two systems becomes quite unmistakable if we keep aside for the moment the remittance operations of the Government of India and the Secretary of State, which becloud the true features of the Indian currency system. If we tear this veil and take a close view, the following appear to be the prominent features of the Indian system :—

(1) The gold sovereign is full legal tender.

(2) The silver rupee is also full legal tender.

(3) The Government undertakes to give rupees for sovereigns, but does not undertake to give sovereigns for rupees, i.e. the rupee is an inconvertible currency unlimited in issue.

Turning to the English system of currency during the period of the Bank Suspension, we find:—

(1) The gold sovereign was full legal tender.

(2) The paper notes of the Bank of England circulated as money of general acceptability by common custom if not by law.

(3) The Bank of England undertook to give notes for gold or mercantile bills or any other kind of good equivalent, but did not give gold for notes, i.e. the notes formed an inconvertible currency unlimited in issue.

Only in one respect can the analogy be said to be imperfect. The Indian Government has undertaken—not, be it noted, as a statutory obligation, but merely as a matter subject to the will of the executive, to convert the rupee into gold at a fixed rate for foreign remittances if the exchange falls below par.

This, it must be allowed, the bank of England did not do during the suspension period. Everything, therefore, turns upon the question whether this much convertibility is a sufficient distinction to mark off the Indian currency from the English currency of the suspension period into a separate category and invalidate the analogy herein said to exist between the two systems. To be able to decide one way or the other we must firmly grasp what is the true import of convertibility. Prejudice against an inconvertible currency is so strong that people are easily satisfied with a system which provides some kind of convertibility, however small. But to assume this attitude is to trifle with a very crucial question. We must keep dear in our mind what it is that essentially marks off a convertible from an inconvertible currency. The distinction commonly drawn, that the one is an automatic and the other is a managed currency, must be discarded as a gross error. For, if by a managed currency we mean a currency the issue of which depends upon the discretion of the issuer, then a convertible currency is as much a managed currency as an inconvertible currency is. The only point of contrast lies in the fact that in the management of a convertible currency the discretion as to issue is regulated, while in an inconvertible currency it is unregulated. But even if regulated the issue remains discretionary and to that extent a convertible currency is not so safe as to mark it off from an inconvertible currency. The enlargement of its issue being discretionary and the effect of such issues being to drive specie out of circulation, a convertible currency may easily become inconvertible. The difference between a convertible and an inconvertible currency is therefore ultimately a distinction between a prudent and an imprudent management of the right to issue currency. In other words, convertibility is a brake on the power of issue. Bearing this in mind, and also the fact that a convertible currency by reason of mismanagement has the tendency to become inconvertible, it is possible for us to imagine how severe must be the obligations as to convertibility in order to prevent prudent management of currency from degenerating into an imprudent management resulting in over-issue. If, therefore, it is true that in countries having a convertible currency the affairs were so prudently managed that when specie left the country the paper money not only did not increase to take its place, but actually diminished, and that usually by a greater absolute amount than the gold currency, it was because the obligations as to convertibility were those of " effective absolute immediate convertibility." We can now appreciate why Prof. Sumner said that

> "convertibility in the currency is like conscientiousness in a man : it has many grades and is valuable in proportion as it is strict and pure."

That being so, it would be foolish to assume that we are immune from the consequences of an inconvertible currency until we know what is the grade of the convertibility that is provided. Now, what is the character of the convertibility of the rupee in India ? It is a deferred, delegalised, delocalised, and therefore a devitalised kind of convertibility. Indeed, really speaking it is not a convertibility, but rather it is a moratorium which is a negation of convertibility, for what does the provision for convertibility for foreign remittances mean in practice ? It simply means that *until* a fall of exchange takes place there is a moratorium or inconvertibility in respect of the rupee. Not only is there a moratorium as long as exchange does not fall, but there is no guarantee that the moratorium will be lifted when a fall does occur. it may not be lifted, for it is a matter of conscience and not of law. Is such a grade of convertibility, if one has a predilection for that term, very far removed from the inconvertibility of the bank notes during the suspension period ? Let those who will say so. For a person not endowed with high and subtle imagination the distinction between such a convertibility and absolute inconvertibility is too thin to persuade him that the two systems are radically different; indeed, when we come to analyse the problem of prices in India and outside India we shall find another piece of evidence to show that they are not different, and that the analogy between the two is perfect enough for all practical purposes.

It may, however, he said that an inconvertible currency may be so well managed as not to give rise to a premium on gold, so that there may be little to choose between it and a perfectly convertible currency. But whether an inconvertible currency will be so well managed is a question of practical working. Again, whether the absence of premium on gold suffices to place an inconvertible currency on par with a convertible currency, so far as the price problem is concerned, is also a matter depending on circumstances. Ail these questions will be considered in their proper places. What we are considering at this stage are the inherent potentialities of an inconvertible currency. Suffice it to say here that the name Gold Exchange Standard cannot conceal the true nature of the Indian Monetary Standard. Its essence consists in the fact that although gold is unlimited legal tender there is alongside an unlimited issue of another form of fiduciary currency well-nigh inconvertible, and also possessing the quality of unlimited legal tender.

It needs no acute power of penetration to see that, so interpreted, the existing currency system in India is the opposite of the system outlined by the Government in 1898 and passed by the Fowler Committee. The two are opposites of each other for the same reason for which the Bank Charter Act was the opposite of the Bank Suspension Act in England. Under both the Acts the currency in England was a mixed currency, partly gold and partly paper.

The difference was that by the Bank Suspension Act the issue of gold became limited and that of paper unlimited, while under the Bank Charter Act the process was reversed, so that the issue of paper became limited and that of gold unlimited. In the same manner, under the original scheme of the Government of India, the issue of rupees was to be limited and that of gold unlimited. Under the existing system the issue of gold has become limited while that of rupee has become unlimited.

Was this an improvement on the plan originally contemplated by the Government of India ? The only objection to that plan was that it made the rupee an inconvertible rupee. But is convertibility such a necessary condition, and, if so, when ? The idea that convertibility is necessary to maintain the value of a currency is, on the face of it, a preposterous idea. No one wants the conversion of bananas into apples to maintain the value of bananas. Bananas maintain their value by reason of the fact that there is a demand for them and their supply is limited. There is no reason to suppose that currency forms an exception to this rule. Only we are more concerned to maintain the value of currency at a stable level than we are of bananas because currency forms a common measure of value. What is wanted to maintain the value of currency, or of any other thing for the matter of that, is an effective limit on its supply. Convertibility is useful, not because it directly maintains the value of a currency, which is nonsense, but because it has the effect of putting a limit on the supply of currency. But convertibility is not the only way of achieving that object. A plan which lays down an absolute limit on issue has the same effect—indeed, a far more powerful effect—on the supply of currency. Now, had the Mints remained entirely closed to the coinage of rupees there would have been placed an absolute limit on the issue of currency, and all the purposes of convertibility would have been served by such an inconvertible rupee. Nay, more ; such an inconvertible rupee currency would have been infinitely superior to the kind of pseudo-convertible rupee which we have in India to-day. With an absolute limit there could have been no danger of a fall in the value of the rupee. If anything there would have been a danger of an indefinite appreciation of the rupee, but that was effectually guarded against by gold having been made general legal tender. A second effect of an absolute limit on the currency would have been to free it from management by reason of the fact that all question regarding the volume of issues had been settled once for all.

In these respects, therefore, the gold-exchange standard is an impairment of the original plan of an inconvertible rupee with fixed limit of issue supplemented by gold. Again, from the standpoint of controlling the price-level, the exchange standard cannot be said to have been an improvement on the original plan. Of course, it is possible to say that such a perversion of the original system is no matter for regret. Whether gold is a standard of value, or whether fiduciary money is a standard of value, is a matter of indifference, for neither can be said to have furnished a stable standard of value. A gold standard has proved to be as unstable as a paper standard, because both are susceptible of contraction as well as expansion. All this, no doubt, is true. Nevertheless it is to be noted that in any monetary system there is no danger of indefinite contraction. What is to be guarded against is the possibility of indefinite expansion. The possibility of indefinite expansion, however, varies with the nature of money. When the standard of value is standard metallic money the expansion cannot be very great, for the cost of production acts as a sufficient limiting influence. When a standard of value is a convertible paper money the provisions as to reserve act as a check on its expansion. But when a standard of value consists of a money the value of which is greater than its cost and is inconvertible, the currency must be said to be fraught with the fatal facility of indefinite expansion, which is another name for depreciation or rise of prices. It cannot, therefore, be said that the Bank Charter Act made no improvement on the Bank Restriction Act. indeed, it was a great improvement, for it substituted a currency less liable to expansion in place of a currency far more liable to expansion. Now the rupee is a debased coin, inconvertible, and is unlimited legal tender. As such, it belongs to that order of money which has inherent in it the potentiality of indefinite expansion, i.e. depreciation and rise of prices. As a safeguard against this the better plan was no doubt the one originally designed, namely of putting a limit on the issue of rupees, so as to make the Indian currency system analogous to the English system governed by the Bank Charter Act of 1844.

If there is any force in the line of reasoning adopted above, then it is not easy to agree with the opinion entertained by the Chamberlain Commission of the Exchange Standard. Indeed, it raises a query whether for all that the Commission said there is not somewhere some weakness in the system likely to bring about its breakdown. It therefore becomes incumbent to examine the foundations of that standard from a fresh point of view.

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